No. 3862 7

United States Circuit Court of Appeals

For the Ninth Circuit

In the Matter of

ELLIOTT-O'BRIEN COMPANY, a Corporation, Bankrupt

S. G. CLIMENSON, as Trustee of ELLIOTT-O'BRIEN COMPANY, a Corporation, Bankrupt,

Appellant

vs.

CARSON, PIRIE, SCOTT & COMPANY, a Corporation; COFFMAN, DOBSON BANK & TRUST COMPANY, a Corporation; BEE NUGGET PUBLISHING COMPANY, a Corporation,

Appellees

Brief of Appellee

CARSON, PIRIE, SCOTT & COMPANY

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Brief of Appellee

CARSON, PIRIE, SCOTT & COMPANY

STATEMENT

This is an appeal from a decree of the District Court which affirmed an order of the referee in bankruptcy, overruling the trustee's objections to the claims of Carson Pirie Scott & Company and certain other creditors, and allowing the claims in full.

Certain payments on account had been made to these creditors at intervals during the "four months period," January 10 to May 10, 1921, by the bank-

rupt, a corporation engaged in the retail dry goods business at Chehalis, Washington, which the trustee regarded as preferential under both (a) the Bankruptcy Act, and (b) the law of the State of Washington, as announced in the so-called "Corporation trust fund" doctrine of that state.

These creditors having submitted themselves to the summary jurisdiction of the Bankruptcy Court by filing proofs of their claims, two courses were open to the trustee with respect to the alleged preferences; either to proceed by a plenary suit for the recovery of the alleged preferences, or to seek their surrender as a condition to the allowance of the claims by filing objections to the claims. The trustee elected the latter course, interposing objections in which he alleged that the payments in question constituted preferences under both the bankruptcy act (Section 60-b) and the state law (trust fund doctrine of the Washington courts).

Appellees contend that where a trustee elects to proceed summarily, as in this proceeding, to compel the surrender of alleged preferences as a condition to the allowance of a claim, rather than by a plenary suit, his rights in such proceeding are governed exclusively by the provisions, and limitations, of sections 57-g and the two sections, 60-b and 67-e, therein mentioned and to be read as parts thereof, which specifically provide for the surrender of certain preferences, limited in all cases, however, to those

occurring within the four months' period and while the bankrupt is "insolvent," as a condition precedent to the allowance of claim.

These provisions of the act, together with the bankruptcy definition of the word "insolvent" as used therein (omitting the portions not applicable here), are as follows:

> SECTION 57-g. "*The Claims of Creditors* who have received preferences voidable under Section sixty, Subdivision b, or to whom transfers void or voidable under Section sixty-seven, Subdivision e, have been made or given, *shall not be allowed unless such creditors shall surrender such preferences.*"

> SECTION 60-b. "If a bankrupt shall have made a transfer of any of his property, **and if, at the time of the transfer** and being within four months before the filing of the petition in bankruptcy, **the bankrupt be insolvent,** and the transfer then operate as a preference, and the person receiving it shall then have reasonable cause to believe that the enforcement of such transfer would effect a preference, it shall be voidable by the trustee."

> SECTION 67-e. "*And all transfers of his property made by a debtor* at any time within four months prior to the filing of the petition against him, **and while insolvent,** *which are held null and void as against the creditors of such debtor by the laws of the state,* shall be deemed null and void under this act."

> SECTION 1. "The words and phrases used in this act shall, unless the same be inconsistent with the context, be construed as follows: (15)

> *A person shall be deemed 'insolvent' within the provisions of this act* whenever the aggregate of his property shall not at a fair valuation be sufficient in amount to pay his debts."

Accordingly it is our contention that, in order to sustain his objections to the claim of Carson Pirie Scott & Company upon the theory that the payments in question were "bankruptcy preferences"—using that term, for convenience, to designate voidable preferences as defined in Section 60-b of the Bankruptcy Act, as distinguished from preferences held void or voidable by state law, which for convenience we will designate as "state-law preferences"—it was incumbent upon the trustee to prove the existence of following elements of a "bankruptcy preference," among others, with respect to each of the payments in question at the various dates they were received: (1) that the bankrupt was *then* insolvent; (2) that the payment *then* operated as a preference; and (3) that Carson Pirie Scott & Company *then* had reasonable cause to believe that the bankrupt was insolvent.

The trustee agrees that proof of these elements are essential to the surrender of the payments as "bankruptcy preferences," and contends that they are established by the evidence with respect to each of the payments to Carson Pirie Scott & Company; while we contend that none of them have been so established.

In this connection we further contend that the referee's finding to the effect that the bankrupt was insolvent during the period in which said payments were received, was a mistaken conclusion from the undisputed facts in the record. The referee's finding to that effect (quoted at p. 15 of appellant's brief), was not approved, or referred to, by the District Judge in his decision.

Judge Cushman, however, decided, in confirmation of referee, that the element of "reasonable cause to believe" was not established, saying:

> "Under the facts and the evidence, whatever date is fixed upon as that on which solvency ended and insolvency intervened, there is no such knowledge or notice of that fact shown upon the part of the alleged preference creditors as the law requires to deprive them of that advantage which they may have obtained." Cushman, J. (R. 28.)

The parties are not agreed as to the essential elements of proof to support the trustee's further theory that the payments in question were also "state-law preferences," available by him as such under his objections in this summary proceeding. The determination of that question involves, primarily, the inquiry as to whether they were, in fact, "state-law preferences" under the "trust fund doctrine" of the Washington courts; and secondly, whether, if so, they were received under such circumstances as to require their surrender as a condition to the allowance of a claim in bankruptcy.

The trustee contends that the only essential elements of proof to establish these payments as "state-law preferences" are: (1) that they were made while the corporation was insolvent in the sense of inability to pay its debts in the due course of business, and (2) that they operated to prefer the creditors receiving them—and this regardless of any knowledge or notice on the part of the latter as to the financial condition of the debtor. The trustee further contends that, if they are thus established as "state-law preferences," he is entitled (as we understand his argument at pp. 59 to 64 of appellant's brief), independently of the provisions of Sections 57-g and 67-e (quoted *supra*), to have the payments thereupon surrendered in this proceeding as a condition to the allowance of the claims, without any further showing, the trustee basing his right in this connection, as we understand, upon Section 70-e of the act.

We contend, *contra,* that it is not enough for the trustee to show simply that these payments were in fact state-law preferences; but that in order to compel their surrender as a prerequisite to the allowance of the claims, he must go further and prove that they fulfill the conditions specified in Section 67-e, necessary to require their surrender under Sections 57-g and 67-e construed in conjunction, namely, that they were made by the debtor within four months prior to the filing of the peti-

tion against it *and while insolvent,* within the bankruptcy definition of insolvency.

The trustee contends that the evidence in the record establishes all of the payments to Carson Pirie Scott & Company as state-law preferences under the Washington decisions—which we do not concede—and also, that they were made not only within the four months' period—which is admitted—but while the bankrupt was "insolvent" in the bankruptcy sense—which is not conceded.

In our view of the case, six questions are, therefore, presented by this appeal, as will be apparent from the foregoing statement (and in stating them we use the words "insolvent" and "insolvency" as defined in the bankruptcy act), viz.:

> 1. Was the debtor insolvent at the times the several payments were made?
>
> 2. Did each payment at the time it was received then operate to give Carson Pirie Scott & Company a greater percentage?
>
> 3. Did Carson Pirie Scott & Company at the time each particular payment was made *then* have reasonable cause to believe that it was receiving a preference?
>
> 4. Are the trustee's rights in this proceeding limited to the provisions of Sections 57-g, 60-b and 67-e, construed in conjunction?
>
> 5. Is the insolvency of the debtor a necessary element of proof, in this proceeding, in order to require the surrender of a transfer (i. e., payment), held null and void as against creditors by state law?

6. Was each of the payments to Carson Pirie Scott & Company made under such circumstances that it properly could be held null and void as against creditors by the law of the State of Washington, under the so-called "trust fund" doctrine of that state?

The case, so far as the rights of Carson Pirie Scott & Company are concerned, was submitted entirely upon the evidence introduced by the trustee, and without substantial conflict in the evidence. Therefore, the questions of fact presented upon this appeal involve consideration merely of the inferences to be drawn from the undisputed facts.

It will assist the court in the latter connection, we think, if we make somewhat clearer than counsel for appellant has attempted to do in his statement, the arrangements under which the business was being conducted and the extent and sources of knowledge of its financial condition possessed by the various witnesses during the period in question.

FACTS

During the time of these transactions Charles H. O'Brien was, to all intents and purposes, the sole owner of the business, owning, and controlling for himself and others of the O'Brien family, all of its capital stock other than that nominally owned by its active manager, Mr. Elliott, whose stock, however, was in the hands of Mr. O'Brien as collateral

security for certain loans. (R. 46, 47, 69, 70.) Mr. O'Brien had been for many years in the employ of Carson Pirie Scott & Company, but had retired from business life some two years previously, and at the time of these transactions was devoting his time to travel, though he still had a desk in the Carson Pirie Scott & Company offices in Chicago. He was not in Chicago, or the State of Washington, during the period in question, but was in the Bermudas on a pleasure trip. (R. 47.)

About the time of leaving on his trip, in November, 1920, Mr. O'Brien, who it appeared had previously given little attention to the actual conduct of the business, visited Chehalis and conferred with the manager, Mr. Elliott, in regard to its affairs and Mr. Elliott's business plans.

It appears that Mr. O'Brien, not caring to be bothered with this business, which he had inherited from his brother, had been desirous for some time of disposing of his own and the O'Brien family's interest in it, having planned at various times to sell the O'Brien interests to Mr. Elliott, or to someone whom Mr. Elliott could find as a purchaser. (R. 40.)

Ascertaining that, as he thought, Mr. Elliott was carrying too large a stock of merchandise and indebtedness, Mr. O'Brien urged Mr. Elliott to reduce both his merchandise and indebtedness as rapidly as possible, with a view, largely, to getting the

investment reduced to a point that would make the business more readily salable as a going concern. (R. 34, 35, 37, 38.)

Mr. O'Brien took occasion, also, to insist upon an early payment of Mr. Elliott's personal indebtedness to him, presumably, since Elliott had no resources of his own, with the idea of stimulating Mr. Elliott to make financial arrangements to take the business off his hands, or to find a purchaser. (R. 50, 73.)

Mr. Elliott differed with Mr. O'Brien in regard to some features of the latter's plans for conducting the proposed stock reduction sales, and felt aggrieved over the demands made upon him for the payment of his personal indebtedness, with the result that he, at that time, considered severing his connection with the business and finally did so about April 26, 1921, proceeding, however, to carry out Mr. O'Brien's wishes in the meantime. (R. 69, 70, 73, 74.)

Shortly after this visit, Mr. O'Brien made arrangements with Mr. Charles L. LeSourd, the trust officer of the Dexter Horton National Bank of Seattle, to look after the business for him, during his absence on his contemplated trip to The Bermudas.

Mr. LeSourd, who was already familiar with the business, by reason of the fact that his bank had acted as administrator of the estate of its former part-owner, Mr. O'Brien's deceased brother, was

informed of Mr. O'Brien's plans for reducing the stock and merchandise, and agreed as to their avisability from the standpoint of procuring a purchaser for the busines, as well as from the standpoint of their sound business policy. (R. 37, 44, 45.)

Presumably anticipating the possibility of Mr. Elliott's leaving the company's employ, and by way of providing for that contingency, Mr. O'Brien and Mr. LeSourd placed Mr. Hart, an experienced dry goods man, who some years previously had been in the employ of Carson Pirie Scott & Company, in the store to assist Mr. Elliott in conducting the contemplated special sales, which were commenced along in December, 1920, and continued at intervals until the appointment of the receiver. (R. 85, 90, 48.)

Mr. Ellott remained, however, as the active manager, personally keeping the books, taking the inventory himself with Mr. Hart's assistance, and generally attending to all the details of the business. Most of Mr. Hart's information as to the financial condition of the business came from Mr. Elliott, who was the one person most intimately acquainted with, and having direct knowledge of, the company's finances during the period in question. Both Mr. Elliott and Mr. Hart reported to Mr. LeSourd from time to time, and conferred with him in regard to the business.

On reaching Chicago, on his extended trip, Mr. O'Brien further arranged to have Mr. Coram T. Davis, a personal friend and an attorney in the offices of Carson Pirie Scott & Company, in Chicago, look after his business affairs in his absence. Mr. O'Brien thereupon wrote to Mr. LeSourd to that effect, requesting him to advise with Mr. Davis on any matters of importance in regard to the store. (R. 37.) So far as appears in the record, Mr. Davis was acting solely in the interest of the owner of the business, Mr. O'Brien, and not in the interest of Carson Pirie Scott & Company, in conducting the correspondence which he had with Mr. LeSourd and Mr. Elliott, a portion of which was introduced in evidence by the trustee.

Mr. Davis evidently was conversant with Mr. O'Brien's plans for reducing the merchandise and indebtedness, with a view, ultimately, to disposing of the business, and the correspondence between Mr. Davis and Mr. LeSourd related principally to the prospects of such a sale, the advisability of accepting certain offers which Mr. Elliott and Mr. LeSourd had received from prospective purchasers of the business, and to the collection of Mr. Elliot's personal indebtedness to Mr. O'Brien. (Trustee's Exhibit "A," R. 115.) Aside from a certain financial statement which Carson Pirie Scott & Company received from the debtor corporation during the period in question, copies of which are among

the exhibits, the only information relative to the debtor's financial condition claimed by the trustee to have been received by this creditor and appearing in the record, was that contained in the letters received by Mr. Davis from Mr. LeSourd.

ARGUMENT

I.

As Bankruptcy Preferences

The payments on account to Carson Pirie Scott & Company were received on the dates and in the amounts, as follows, all of them within the "four months' period":

Jan. 25, 1921	$ 265.50
27, 1921	495.55
Feb. 4, 1921	517.54
24, 1921	661,59
Mar. 5, 1921	715.80
Apr. 1, 1921	589.66
25, 1921	500.00
29, 1921	508.47
	$4,254.11

It is a well settled rule that each payment, in a series of payments on account alleged to be preferential, is to be treated as an independent transaction; and that the burden of proof is upon the

trustee to show the existence of the essential elements of preference with respect to each particular payment, at the time it was made. The rule is clearly stated in *W. S. Peck & Co. v. Whitmer* (C. C. A.), 231 Fed. 893, 896, a case involving payments on account, made a week or more apart during the four months' period:

> "Therefore the burden of proof was upon the trustee to show by a fair preponderance of the evidence (1) that the bankrupt was insolvent at the time the *several* payments were made; (2) that the payments so made enabled appellants to receive a larger percentage of their respective debts than any other creditor of the same class; (3) that *at the time each particular payment was made* appellants had reasonable cause to believe that the enforcement of the payment or transfer would effect a preference."

The importance of bearing this rule in mind in the consideration of this case is apparent, in view of the fact that the payments to Carson Pirie Scott & Company were made at intervals extending over several months in the early part of the year 1921, when the period of drastic deflation following the war was at its height and merchandise values throughout the country were very uncertain and dropping rapidly almost from day to day.

As stated by Mr. Elliott in his testimony, "The merchandise was really receding every month." (R. 75.) So that the financial condition of the debtor, as measured by changing value of its mer-

chandise stock, probably was not the same on the dates of any two of these payments.

As it is conceded that in order to compel the surrender of these payments as bankruptcy preferences within the definition of Section 60-b, in this proceeding, it was necessary for the trustee to prove the elements of: (a) insolvency, (b) greater percentage of payment, and (c) reasonable cause to believe, we will discuss briefly the evidence bearing upon them, in the order named.

(1) WAS THE DEBTOR INSOLVENT AT THE TIMES THE SEVERAL PAYMENTS WERE MADE?

The answer to the question is found in the fact that the evidence introduced by the trustee, which stands uncontradicted in the record, positively and affirmatively shows that the bankrupt was solvent, in the bankruptcy sense of having an excess of assets, throughout the period of the payments to Carson Pirie Scott & Company, as the following brief analysis of the evidence will demonstrate:

Disregarding, for the moment, whatever evidence there may be in the record as to the value of the assets and the amount of liabilities on any date or dates subsequent to April 29, 1921, the date of the last of the payments in question to Carson Pirie Scott & Company, and confining our inquiry to the period during which those payments were

made and prior thereto, let us turn to the showing of the debtor company's assets and liabilities up to the date of the last payment, as shown by the evidence introduced by the trustee:

It will be recollected in this connection that Mr. Elliott, the manager, and a witness in behalf of the trustee, was the one person, as the record shows, who purported to have direct and intimate knowledge of the debtor company's financial condition. He had had the sole conduct of the business since its inception in 1917, as one of the original incorporators and its secretary-treasurer and manager, (R. 46, 69), which meant that he personally had purchased the merchandise on hand during the period covered by these payments and had better means of knowing its quality and value than any outsider could have had. Also he personally kept the books; and it was in connection with his testimony that all the books and statements showing the financial condition of the debtor company were identified, explained and introduced.

No other witness was examined, or testified, as to the amount or value of the assets or liabilities as they existed during this period.

So that his testimony in that regard stands undisputed and uncontradicted in the record, as does the data disclosed by the said books and statements.

What, then, are the undisputed facts so shown?

First, that the debtor company had *a net worth of $14,230.35, on December 31, 1921,* as shown by the entries in its trial balance book (Trustee's Exhibit "B"), of that date, and the statement of December 31, 1920 (Respondent's Exhibit "No. 2," R. 162), and *based upon an actual inventory* made by Mr. Elliott in the usual course of business, which he testified he was very careful in taking, as nearly as he could *at market values,* writing off from the various inventory sheets, after they were first totaled, some $2,500.00, by making reductions on different items, so that "when completed the inventory was really placed at the market value." (R. 67, 68.)

This was a few weeks prior to the first payment to Carson Pirie Scott & Company.

Second, that the debtor company had *a net worth of $2,945.07 on April 26, 1921,* as shown by the entries in its trial balance book (Trustee's Exhibit "B"), of that date, and *based upon an actual inventory* made by Mr. Elliott between the dates of April 23 and 26, just prior to his leaving Chehalis, concerning which he testified:

> "I took the inventory on April 23, on exactly the same basis as before (referring to the previous inventory above mentioned), only did not go over it again and mark it down, but took it at what I thought was the *market price.*" (R. 68.)

This was only three days prior to the last payment to Carson Pirie Scott & Company.

Third, that at the close of each of the intervening months the debtor company had a net worth as shown by the entries made by Mr. Elliott in its trial balance book (Trustee's Exhibit "B", R. 152), as follows:

"Net Worth."

"January	$11,752.98"
"February	11,608.85"
"March	11,444.97"

which, Mr. Elliott testified, necessarily involved estimated inventories, made by him at "a reduction of 30% to 25%," for those three months, since no actual inventories were taken during those months, but which, as he also testified, were otherwise based on actual figures (R. 53, 54), and, therefore, represented correctly the company's financial condition, as nearly as Mr. Elliott could arrive at it without an actual inventory.

As against this positive evidence, relating directly to the period in question, affirmatively showing solvency, and binding upon the trustee since it was introduced on his behalf, how can he be heard to contradict it by inferences deduced from the amount of the receiver's inventory, or of the amount realized at the bankruptcy sale?

But if that were permissible under the rules of evidence—and we respectfully submit the contrary—how can it be argued with any degree of per-

suasiveness that the receiver was any more competent to judge of the value of that particular stock than Mr. Elliott, the man who had purchased it and handled it and possessed a detailed knowledge of its quality and value? Mr. Walker testified (R. 82), that he had been in the retail mercantile business for a good many years and had been assessing merchandise stores in Lewis County for a number of years, which he said gave him "quite an inside knowledge of merchandising." (R. 82.) He does not say how recently he had been in the retail business or whether in a similar, or different, line to that of the debtor. But it is difficult to see how his duties as assessor in Lewis County would better qualify him to judge of the fair market value of this particular stock than Mr. Elliott, who had been actively engaged in the dry goods business, wholesale and retail, for about fourteen years immediately preceding.

Also we think the court will take judicial knowledge of the commonly recognized tendency of both tax-assessors and receivers to under-value rather than over-value stocks of merchandise.

Judging from the ordinary experience in bankruptcies, the fact that this estate "came over into bankruptcy with an inventory valuation of approximately $12,000 and a proved indebtedness of approximately $16,000 and immediately sold for $11,000 net—after just having gone through a so-called

"closing out sale" which counsel for appellant describes in his brief (p. 47) as one of "slashing prices, through a special sales agent, under heavy pressure," and which evidently left the stock, as Mr. Walker, the receiver, testified, in a badly demoralized condition with staple articles like sheetings and ginghams all gone, with broken lines in nearly every department, with unseasonable articles left on hand, and others more or less damaged and showing the effect of improper handling by unexperienced sales people (R. 83), and after undergoing in addition to that the "shock and shrinking process" of a state court receivership, followed by bankruptcy—the very fact, we suggest, that the assets after encountering such a demoralizing ordeal immediately preceding bankruptcy, thereupon sold for $11,000 net, or approximately 70% of the proved indebtedness of $16,000, indicates conclusively, in our view, that the fair market value of the assets, while the debtor company was still a going concern, was more than sufficient to cover its liabilities. And particularly so, in view of the additional fact that the receiver's sale occurred at a time of serious financial depression, when buyers of merchandise stocks would be comparatively few and cautious in bidding. This view seems to be substantiated by the fact that the purchaser at the receiver's sale afterward told the latter "that he had done better than he had expected." (R. 84.)

It is clear, we think, from the foregoing analysis of the undisputed evidence, not only that the trustee has established the fact of solvency throughout the period of the payments to Carson Pirie Scott & Company by affirmative evidence which precludes him from urging mere inferences from other evidence in the record, and relating to a time subsequent to the period in question when the entire situation was radically changed, to overcome it; but that there are, indeed, no such legitimate inferences to be drawn.

It is true that the referee found that the bankrupt was insolvent.

It is the recognized rule, however, that where the finding of a referee is a deduction from established facts or uncontradicted testimony, not involving questions of credibility, neither the District Court on review, nor the Circuit Court on appeal, is bound by the referee's finding; but, having the same facts before it, either court is at liberty to draw its own conclusions. *Walter v. Atha,* (C. C. A.), 262 Fed. 75, 45 Am. B. R. 365; Collier on Bankruptcy (1921 Ed.), p. 605.

In stating his conclusion on the question of solvency, the referee said: "I have no doubt *from this resume of the figures* that the bankrupt was insolvent in December, 1920," (R. 21), referring to certain figures of the company's indebtedness, sales, purchases, inventory, net worth and operating ex-

penses during the four months' period, which were taken by the referee, as he states, from the company's records as testified to by Mr. Elliott, together with the amounts of the receiver's inventory and sale of assets and of the proved debts, all of which figures are set out by the referee in the preceding paragraphs of his certificate.

And in the paragraph immediately following the statement of his conclusion as above, the referee by a computation of his own, from figures of the bankrupt's merchandise, and bank indebtedness, inventory and fixtures, as he understood them to exist in December, explains how he arrived at his conclusion of insolvency as follows:

> "In December, 1920, the bankrupt owed for merchandise about $16,240.92 and owed the bank $5,500.00, making a total known indebtedness of $21,740.92. Its inventory taken about December 31, 1920, was about *$26,371.39,* about $4,000.00 of which covered fixtures, leaving the net stock about $22,371.39, or about *$630.47* more than the known debts. It would cost, and did cost, more than $630.47 to convert the stock into cash for the payment of debts. In fact it cost about $12,000, *so that* insolvency existed then and never got any better." (R. 21.)

It will be observed that the figures used by the referee in this computation must have been taken from the face of the bankrupt's books of account, since the books, with the witness Elliott's explanation of the entries therein, are the only source of such information in the record; and that the referee,

although he uses the rather indefinite expression, "in December," clearly intended this computation to relate to the close of that month, since he uses the inventory "taken about December 31, 1920," as the basis of his comparison of assets with liabilities.

It would be expected, therefore, unless there is some mistake in the figures used by the referee, that the result reached by him would not differ widely from the net worth on December 31 as shown by the books. But the referee in his computation arrives at a net worth of only *$630,* as compared with the net worth of *$14,230* shown by the books (see statement of December 31, 1920, Respondent's Exhibit "No. 2," R. 162), a discrepancy of $13,600, which is only partly accounted for by the fact that the referee expressly eliminates from his consideration, as part of the assets—and clearly improperly, we need hardly suggest—fixtures to the extent of about $4,000.

Thus there is still an unexplained discrepancy of about $9,000 between the referee's computation of net worth on December 31 and the net worth as shown by the books for that date.

A comparison between some of the figures used here by the referee and the corresponding items as shown by the company's said statement of December 31, 1920, as tabulated below, makes it clear that the referee used the wrong figures in his computa-

tion and thereby reached an entirely mistaken conclusion:

Items—	Referee's Figures.	Figures per Statement.
Owing for merchandise	$16,240.92	$12,958.11
Owing to bank	5,500.00	5,792.89
Total indebtedness	21,740.92	18,751.00
Inventory—		
Merchandise	22,371.39	27,862.25
Fixtures	4,000.00	3,520.22
Net worth	630.47	14,230.35

We have been unable to discover from the record where in the company's books the referee obtained the figures he uses, but we are inclined to think that he inadvertently took the items of indebtedness shown by the trial balance book as of some other date than December 31, possibly as of the first of the month instead of the last.

But however the mistake may have occurred, it is clear, we think, for the reasons we have pointed out, that the referee was wrong in his calculations, resulting in a mistaken conclusion of insolvency in his findings.

(2) DID EACH PAYMENT AT THE TIME IT WAS RECEIVED THEN OPERATE TO GIVE CARSON PIRIE SCOTT & COMPANY A GREATER PERCENTAGE?

Whether or not any one of the creditors, including Carson Pirie Scott & Company, in accepting a payment in full, or on account, on any one of the

dates on which a payment was made to Carson Pirie Scott & Company, then received a preference, obviously depends first of all upon the fact of solvency or insolvency on that particular date.

If the debtor was then solvent and distribution was immediately made, no creditor would be at a disadvantage.

But assuming that insolvency appeared, it would still be necessary to ascertain whether the payment to a particular creditor on that date amounted to a greater percentage of his then claim than the percentage received by any other creditor on the same date on his then claim. The essential factors in this problem would be: (1) total assets, (2) total liabilities, (3) amount of each claim, (4) amount of each payment—*on the particular date.*

We are unable to find this requisite data in the record, as of any one of the dates of payment to Carson Pirie Scott & Company, and therefore submit that the trustee has failed to sustain the burden of proving this admittedly essential element of a "bankruptcy preference" with respect to any of said payments.

(3) DID CARSON PIRIE SCOTT & COMPANY AT THE TIME EACH PARTICULAR PAYMENT WAS MADE THEN HAVE REASONABLE CAUSE TO BELIEVE THAT IT WAS RECEIVING A PREFERENCE?

The rule as to what will and will not constitute knowledge of the fact of a preference, is very concisely stated in the opinion of Archibald, J., *In re Coder v. McPherson,* 152 Fed. 951, 953; 89 C. C. A. 99, quoted in appellant's brief, as follows:

> "Notice of facts which would incite a man of ordinary prudence to an inquiry under similar circumstances is notice of *all the facts which a reasonably diligent inquiry would disclose.*" (Italics ours.)

What would incite the ordinary business man to inquiry; what would constitute a reasonably diligent inquiry; and what such inquiry would have disclosed, depend, of course, upon the circumstances of the particular case.

Knowledge which would incite inquiry in one instance may be overcome by the existence of additional information in another instance. As said by Judge Archibald, in concluding his opinion in another very carefully considered case, stronger against the creditor, we think, on the facts, than the instant case:

> "No doubt in the present instance Allendar (the creditor) was anxious over his debt, and pressed for its payment, and may have ex-

> pressed apprehension with regard to it. But this is not to be carried too far, or made to operate too strongly against him, *particularly in view of the assurances which he had received from those best calculated to know,* on which he had the right to rely, to the contrary."
>
> *In re Wolff,* 164 Fed. 449, 458.

In that case the creditor had pressed for payment; had threatened suit; had been told by an officer of the debtor company that the company was indulging in operations the outcome of which was not encouraging; had expressed doubt as to the safety of his loan; had been told by an officer of the company that his debt was not paid because the company "had no money"; knew that a reorganization scheme had fallen through; had been promised payment within ten days and on the failure of the company's representative to meet an appointment to carry out that promise, had threatened suit; had been told that if he sued it would precipitate matters and that he and other creditors would get less, but that if he waited he would get his money; and within a couple of days thereafter, the money not being forthcoming, he accepted an assignment of an account as security. On the other hand he had been assured by the president, as a personal friend, of the safety of his debt, with plausible explanations of the company's difficulties.

The court, after reviewing the facts in his opinion, substantially as above, said:

> *"While, then, there may have been abund-*

> *ant signs of embarrassment, the same cannot be charged as to insolvency.* The most that can be said is that there was enough to put Mr. Allendar (the creditor) on inquiry. But where could he inquire that he had not? Or *what further could he hope to elicit? . . . Nor can he be charged with notice that the condition of the company was other or different than had been so represented to him* (referring to the assurances given him of the safety of his debt). . . . The special master has made an admirable report, from which I may well hesitate to differ. . . . But he was particularly mistaken, as I am constrained to feel, in holding that, all things considered, there was reasonable cause to believe that the company was insolvent, so as to make the transfer of the security in question a preference *which further inquiry if prosecuted, would have disclosed.*" *In re Wolff, supra.*

While the facts inciting to inquiry are so much stronger in the *Wolff* case than in the instant case that it cannot be maintained here with any degree of reason, in the light of that ruling, that Carson Pirie Scott & Company was put upon inquiry, let us turn now to the undisputed facts in this record for the purpose of ascertaining *what a reasonably diligent inquiry would have disclosed* to Carson Pirie Scott & Company, assuming, but by no means admitting, that they were indeed put upon inquiry.

> "A spring can rise no higher than its source."

Mr. Elliott was the most authentic, and the ultimate, source of information in regard to the com-

pany's affairs, and the one person of whom inquiry naturally would have been made. The evidence shows that he is a thoroughly experienced dry goods man, in whom Carson Pirie Scott & Company had every reason to place confidence. His testimony will impress the court, we think, as having been given freely and with every indication of candor. It is not impeached or contradicted. The trustee vouched for him, as his witness.

Mr. Elliott's testimony clearly indicates that he himself believed that the inventories he took, at the beginning and close of the period in question, were correct (R. 54), and based upon market values (R. 67), and that he, therefore, must have believed that the business was solvent, since the trial balances based upon those inventories showed it to be solvent.

Mr. LeSourd, the trust officer of one of Seattle's leading banks, and whose testimony in this matter is, we suggest, of particular value and entirely trustworthy, testified, in response to a question asked him by counsel for the trustee, that "neither Elliott nor O'Brien had any idea in their minds, from what they said (in December) that the company was insolvent at the time—never mentioned it." (R. 38.) Further on Mr. LeSourd testified, on cross-examination, to the effect that as late as May 2, "neither Mr. Elliott nor Mr. O'Brien, so far as he knew, had any idea that the store would be

closed at that time," but that they "expected it would be continued as a going concern." (R. 44.)

Thus it appears from Mr. LeSourd's testimony, as well as from Mr. Elliott's, that Mr. Elliott himself believed up to the time he left Chehalis, that the business was solvent and would continue as a going concern. And it cannot be presumed that he would have informed Carson Pirie Scott & Company to the contrary. The company's books, if this creditor had requested to see them and Mr. Elliott had seen fit to comply with such a request, would have confirmed Elliott's opinion that the debtor company still was solvent. They would have shown a net worth ranging from $14,000 to $11,000 on any day Carson Pirie Scott & Company might have made inquiry up to April 27, the day following the completion of the last inventory, and they had no occasion to inquire then, because Mr. LeSourd's letter of April 23 clearly indicated that they would be advised of the company's actual condition when that inventory was completed.

Elliott testified also that at no time, up to the time he left in April, was any creditor seeking to enforce its claim by law (R. 74); and he naturally would have informed Carson Pirie Scott & Company of that assuring circumstance.

So that neither inquiry of Elliott nor an examination of the books would not have disclosed an

excess of liabilities over assets during the period in question.

If a representative of Carson Pirie Scott & Company had talked with Mr. Hart, he would have been informed by the latter, according to Hart's opinion as testified to in this matter, up to the date of the appoinntment of the receiver, that, in his opinion, "the capital stock still had value," and that he "still had faith in the store." (R. 92.)

If their representative had inquired of Mr. LeSourd, who was keeping in close touch with the company's affairs, as the personal representative, locally, of the owner of the business, Mr. O'Brien, he would have learned from him—judging by Mr. LeSourd's testimony, and the letters and telegrams he was sending to Mr. Davis, as Mr. O'Brien's "personal representative" in Chicago (R. 37)—that he did not know of any creditors who were trying to enforce their claims or who entertained a wish to do so (R. 44). If such inquiry had been made as late as March 12, the time of the "Worth offer," Carson Pirie Scott & Company would have been told by Mr. LeSourd that he considered that 90 per cent of the stock of merchandise then on hand at the then replacement values "would *at least pay the debts* and possibly a little on the capital stock." (R. 39.) And the investigator could not have learned from Mr. LeSourd until as late as May 2, after all the payments had been made, that insolv-

ency existed; for Mr. LeSourd testified that "the first knowledge" he "ever had that the store was insolvent" was on that date (R. 41).

If inquiry had been made, as late as the latter part of March or early in April, of the Western Dry Goods Company, in Seattle, one of the largest creditors, and if that company had seen fit to inform him of the facts as they appear in the record he would have learned that their credit man, Mr. Beamer, was then satisfied with the Elliott-O'Brien Company's situation as he had recently found it after personally visiting the store, looking over the merchandise and talking with the manager, Mr. Elliott. (R. 72-73.)

If inquiry had been made of the debtor company's bankers in Chehalis, Carson Pirie Scott & Company would have learned from them, down to as late as May 3 or 4 (after all the payments in question had been received by Carson Pirie Scott & Company), that so far as they knew the debtor company was solvent and in no difficulty, and that the bank was carrying their account practically in the same amount as it had for years (R. 107-108), and that, notwithstanding the "closing out sales" which they were advertising, it was not generally understood locally that the company was going to close its business—not unless they found a purchaser (R. 109).

Clearly this would have constituted a reason-

ably diligent inquiry on the part of this creditor and the facts and opinions so received in response to it certainly would not have warranted the conclusion that the debtor's liabilities exceeded its assets, but would have led to the opposite conclusion.

Appellant does not claim that Carson Pirie Scott & Company had any information specifically to the effect that the debtor company's liabilities exceeded its assets; nor does he attempt to show that reasonable inquiry on its part would have disclosed such a condition at the time of any of the payments. On the contrary the evidence introduced by him showed that at the beginning of the four months' period this creditor was furnished (R. 115) with a statement (Respondent's Exhibit No. 2), of the assets and liabilities, showing a net worth of more than $14,000; and the very communications of Mr. LeSourd to Mr. Davis, introduced by the trustee, upon which appellant's counsel places so much stress as containing notice to Carson Pirie Scott & Company of a possible or impending receivership (and therefore of insolvency, as counsel would have the court infer), in each instance contained other information, of a reassuring nature, specifically upon the subject of the debtor's assets and liabilities, viz.: The telegram of March 12 stated that Elliott showed assets and liabilities as listed in the telegram, the totals of which gave a net worth of $9,650 (R. 129); the letter of March

16 stated that "the stock is evidently worth somewhat in excess of the debts," and that in addition there were the "fixtures carried on the books at between $3,000 and $4,000 (R. 123-124), and the letter of April 23, which reached Carson Pirie Scott & Company about two days before the last payment, stated the approximate total of the liabilities and contained the information that an inventory was to be taken beginning the next day which would enable the true condition to be determined (R. 149-150).

The above mentioned communications contained the only information shown by the record to have been received by this creditor as to the debtor's assets and liabilities during the period in question.

As against this positive information that the debtor's assets were in fact in excess of its liabilities, what does the trustee urge as showing notice to Carson Pirie Scott & Company to the contrary?

First there are the communications of Mr. LeSourd just referred to, viz., the telegram of March 12 in which he advised: "Fear receivership if business drifts along"—this accompanied by a summary of the assets and liabilities, listed in the same telegram, showing a net worth of $9,650—(R. 120); the letter of March 16, advising "this (reducing the stock to ten or fifteen thousand dollars by selling it gradually to customers) is probably going to be difficult to accomplish as someone *might* step in

and demand that a receiver be appointed"—this accompanied by Mr. LeSourd's opinion that there was "no object in giving the stock away" (to a purchaser at less than 100 cents on the dollar), and that "the stock is evidently worth somewhat in excess of the debts"—(R. 123-124); and the letter of April 23, advising, "*If* it seems impossible for the store to pay its debts we will suggest that all stock be turned over to the creditors at once"—accompanied by the information that an inventory was about to be taken, commencing the next day, which would determine that question. (R. 149-150.)

Aside from these advices of the possibility of a receivership, which of themselves manifestly do not convey the impression that the debtor company was insolvent in the sense of having less assets than obligations, and more particularly because the first two contained specific information to the contrary, and the last showed that those in charge of the store did not themselves know the true condition at the date of writing but were taking an inventory to ascertain, and would act accordingly—the only other circumstances urged by appellant as constituting notice of insolvency are: The intimate relation between Mr. Elliott and the O'Briens with Carson Pirie Scott & Company, the liberal extension of credit by this creditor to the debtor and their extensive dealings in the past, the business depression, the fact that some of this creditor's bills

were more than one year old, and that they knew that fact, the refusal of this creditor in February to sell the debtor any more goods on credit, the disagreements between Mr. Elliott and Mr. O'Brien and the fact that by reason of Mr. Elliott's application for a position in their employ in March Carson Pirie Scott & Company knew that he intended to give up his position with the debtor corporation while Mr. O'Brien was in the Bermudas, the fact that Carson Pirie Scott & Company afterward took Mr. Elliott back into their employ, the fact that this creditor knew that the debtor was running continuous sales and was seeking a purchaser for the business. (Appellant's Brief, pp. 33-39.)

It may be observed by way of passing comment on these circumstances, that:

With respect to the alleged intimate relationships between Elliott, the O'Briens and Carson Pirie Scott & Company; the facts are that one of the O'Briens had been deceased for over a year, the other was in the Berumdas and knew nothing about the financial condition of the store during these four months, and Elliott had not been connected with Carson Pirie Scott & Company for a matter of four years. So far as that past relationship had any bearing, it doubtless tended to make Carson Pirie Scott & Company rely the more implicitly upon the information it received to the effect that the assets were in excess of the liabilities.

The fact that, after extending a liberal line of credit during the period of war-inflation—during which the debtor took advantage of discounts with practically all its other creditors and of being permitted to pay its bills to Carson Pirie Scott & Company at its convenience with interest—this creditor, during the subsequent period of deflation, along with other wholesale houses throughout the country, insisted upon debtor's carrying a more reasonable stock of merchandise and getting back to "normalcy" in the payment of its account, as a condition to further purchases on credit, would not indicate, by any means, that Carson Pirie Scott & Company had reason to believe the debtor insolvent, but rather that it was seeking merely to get its dealings with the debtor back to a sound business basis. Doubtless the business depression made that course necessary with other customers generally.

Carson Pirie Scott & Company's knowledge of past due indebtedness owing to it would not necessarily cause it any serious concern, for the simple reason that the debtor's account had been in that condition from the beginning. Mr. Elliott testified that they "had always had a substantial account with the debtor—a big claim past due—ever since the latter began business, and that there was nothing unusual about that past due claim—not after the first six months" (R. 71).

As to Carson Pirie Scott & Company's employment of Elliott and their knowledge of disagreements between Elliott and O'Brien: If Carson Pirie Scott & Company knew of the disagreement, they also must have known that it resulted from Mr. O'Brien's criticism of Mr. Elliott's management in carrying too big a stock and too large an indebtedness, and that Mr. O'Brien had arranged to have a capable man, Mr. Hart, in the store ready to carry out his plans in case of Elliott's resignation, which it appears was under contemplation by Mr. Elliott since November of the preceding year. (R. 50, 71, 73.) Mr. Elliott's application for a return to their employment would not, under such circumstances, indicate that he was leaving the debtor company because he considered it insolvent, as opposing counsel seeks to have the court infer. There is nothing in the evidence, we suggest, to warrant counsel's assertion that Elliott "abandoned" the debtor corporation. On the contrary, it shows that he made arrangements with Mr. LeSourd about turning over the management to his successor, Mr. Hart, and stayed over several days after he had planned to leave and took an inventory.

As to the carrying on of special stock reducing sales by the debtor advertised as "closing out sales": Upon appellant's theory that the information contained in Mr. LeSourd's letters to Mr. Davis thereby came within the knowledge of Carson Pirie

Scott & Company, they knew that the object of those sales was to reduce the merchandise stock and indebtedness to a point where a purchaser for the business as a going concern could be more readily obtained. Also this was in accordance with the return to a sound business policy upon which Carson Pirie Scott & Company was insisting with respect to its account. The sales as well as the fact that a purchaser for the business was being sought, were advertised openly in the newspapers. They did not incite any of the Seattle or Portland creditors to make inquiry (R. 91). On the contrary, it appears that Mr. Beamer, the representative of the Western Dry Goods Company of Seattle, one of the largest creditors, on visiting the store late in March or early in April, was informed of the special sale about to be put on in April and that Elliott thought they would "take care of everybody," whereupon Mr. Beamer "expressed his satisfaction." (R. 73.)

Counsel for appellant in his brief (pp. 32-33) contends that the fact that Carson Pirie Scott & Company did not offer any of the correspondence exchanged between it and the bankrupt establishes an inference of law "that such evidence, if produced, would have been fatal to its case," meaning, we take it, that such correspondence would show conclusively that Carson Pirie Scott & Company had "reasonable cause to believe." (How it could be "fatal" to Carson Pirie Scott & Company's case is difficult to un-

derstand, since it could have a bearing only on the element of "reasonable cause to believe.")

We have examined the decisions cited by appellant in support of this contention and find that they are not in point, for the reason, among others, that they relate to oral testimony rather than to documentary evidence, with respect to which a somewhat different rule seems to obtain, due to the fact that a document speaks for itself and can be availed of by an adverse party without the risks attending the examination of an adverse or hostile witness.

While the true rule as to presumptions arising from non-production of evidence does not go to the extent of an inference that if produced the evidence would be "fatal" to the party's contention, but only to the extent that it would be unfavorable, the rule, it seems, does not apply in cases where, as here, no notice to produce documentary evidence has been given:

> "(2) *Non-production of Documents*: Where a party to judicial proceedings suppresses documents which are relevant to the matter in question and within his control, . . . there is a presumption that the suppressed evidence would injure his cause.
>
> "*Notice to Produce*: The unfavorable inference is especially applicable where the party withholding has had notice or has been ordered to produce documents in his possession; *and conversely,* it has been held that *unless the party desiring the production of documentary evidence gives notice to the party in whose possession it is to produce it,* no unfavorable presumption or

inference can arise from its non-production." 22 C. J. 114.

(Citing *Watkins v. Pintard,* 1 N. J. L. 432; *Sullivan v. Cranz,* 21 Tex. Civ. App. 498, 152 S. W. 272; *Rochester Ins. Co. v. Monumental Sav. Assn.,* 107 Va. 701, 60 S. E. 93.)

No notice to produce the correspondence referred to was ever given, nor was its production ordered or requested, as the record will show.

With respect, therefore, to the contention of appellant that the payments to Carson Pirie Scott & Company constituted voidable preferences within the meaning of Section 60-b of the Bankruptcy Act, and that, as such, their surrender was required under the trustee's objections in this proceeding; we respectfully submit that the trustee not only has failed to sustain the burden of proving any of the three essential elements of such a preference as to any of said payments, but has affirmatively shown the non-existence of all those elements as to each of said payments.

II.

As "State-Law Preferences."

(4) ARE THE RIGHTS OF THE TRUSTEE IN THIS PROCEEDING CONFINED TO THE PROVISIONS OF SECTIONS 57-g, 60-b AND 67-e CONSTRUED IN CONJUNCTION?

For convenience of reference, we will again quote those sections here, omitting the portions not applicable to this proceeding:

Section 57-g: *"The Claims of Creditors* who have received preferences voidable under Section 60, Subdivision b, or to whom transfers void or voidable under Section 67, Subdivision e, have been made or given, *shall not be allowed unless such creditors shall surrender such preferences."*

Section 60-b: "If a bankrupt shall have made a transfer of any of his property, and if, at the time of the transfer and being within four months before the filing of the petition in bankruptcy, the bankrupt be insolvent, and the transfer then operate as a preference, and the person receiving it shall then have reasonable cause to believe that the enforcement of such transfer would effect a preference, it shall be voidable by the trustee."

Section 67-e: "And all transfers of his property made by a debtor *at any time within four months prior to the filing of the petition against him,* AND WHILE INSOLVENT, which are held null and void as against the creditors of such debtor by the laws of the state, shall be deemed null and void under this act." (Italics ours.)

The bankruptcy act contains various provisions under which the trustee may bring *suit* to recover preferential transfers which the creditors might have recovered if bankruptcy had not intervened.

Among them is Section 70-e, quoted at page 49 of appellant's brief, and under which he claims the right to enforce, in this summary proceeding, the surrender of the payments in question.

All of the decisions cited by appellant in his brief (pp. 49-63) in support of his right to enforce

a surrender in this proceeding under Section 70-e were in cases in which the trustee was *suing* to recover a preference, and are therefore not in point, the question here presented being directed, not to the rights which the trustee may have to recover preferences by a plenary suit or action, but solely to the trustee's right to enforce a surrender in bankruptcy as a condition to the allowance of a claim.

None of the cases cited by appellant in this connection (Appellant's Brief, pp. 49-63) go further than to sustain the trustee's right to recover "state-law preferences" under Section 70-e in a plenary suit or action, which for the purpose of this argument may be admitted.

Section 57 contains the provisions of the bankruptcy act providing for, and governing, the proof and allowance of claims. The method provided is a summary proceeding for that purpose in the bankruptcy court. Subdivision g of this section confers a right, not otherwise existing, whereby the trustee may reach preferences through this summary proceeding, not to the extent of recovering the preference, but merely to the extent of compelling its surrender as a condition to the allowance of the preferred creditor's claim. And that right, it will be noted from the wording of Section 57-g, does not extend to all preferences recoverable under the act, but is limited to those preferences expressly specified in Section 57-g, viz: *First,* "preferences voida-

ble under Section 60-b," and *second,* "transfers, etc., void or voidable under Section 67-e."

By specifying the particular preferences the surrender of which may be so compelled, the statute by its very terms excludes all other preferences from its operation; and, since Section 57-g is the only provision in the act empowering the court to require the surrender of preferences as a condition to the allowance of claims, it necessarily follows that the rights of the trustee in this proceeding are confined to, and governed by, Section 57-g and the two sections, 60-b and 67-c, therein mentioned.

This construction of the statute seems plain from the wording of the statute itself; and we find that it is the construction placed upon Section 57-g by the Supreme Court.

In *Western Tie & Timber Co. v. Brown,* 196 U. S. 502, 49, N. E. 571, a case in which a claim in bankruptcy had been ordered expunged unless the creditor surrendered certain alleged preferential payments claimed by the trustee to be voidable under Section 60-b, Mr. Justice White, in deciding that the court below had erred in finding that the payments in question were voidable preferences under that section, and had therefore erred in requiring their surrender as a condition to the allowance of the claim, *held,* in effect, that Section 57-g as amended in 1903 is jurisdictional, "empowering the (bankruptcy) court to compel creditors to sur-

render preferences as a prerequisite to the proof of claims" against the estate of a bankrupt, and that it "relates only to those creditors" who have received preferences as specified therein.

The following quotations from the text writers amply support this very obvious construction:

After explaining that, prior to its amendment in 1903, Section 57-g, which originally read, "The claims of creditors who have received preferences shall not be allowed," etc., without specifying what preferences,—the words "voidable under Section 60, Subdivision c, or to whom transfers void or voidable under Section 67, Subdivision e, have been made or given," having been inserted by the amendment—was found to be unsatisfactory in its operation, the author of "Collier on Bankruptcy," in discussing the effect of the section in its present amended form, says:

> "Congress has responded by amendment (1) making it certain that no transaction more than four months before bankruptcy is a preference *and* (2) *limiting that which must be surrendered as a condition precedent to proving a debt to* (a) preferences that are 'voidable under Section 60, Subdivision b,' and (b) advantages possessed by creditors 'to whom conveyances, transfers, assignments or encumbrances, void or voidable under Section 67, Subdivision e, have been made or given. . . . Considered broadly, Subsection g seems now to mean . . . He who has obtained an advantage over other creditors in any of the ways

indicated in the present law (i. e., Section 57-g) *and only such an one, must hereafter surrender* his advantage before his claim can be filed or allowed."

. . . .

"The effect of this change in Section 57-g is to make *only those preferences voidable* (necessary to be surrendered on objection to claim) which are made so by Section 60-b, or by Section 67-e, which latter refers only to conveyances made with intent to defraud creditors or rendered invalid by some statute (law) of the state."

Collier on Bankruptcy (1921 Ed.), pp. 803-804, paragraphs (2), (3), (4).

The author of the article on "Bankruptcy" in "Ruling Case Law" places the same construction upon this section as amended. He says:

"*Surrender of Preferences*: . . . If an alleged preference was not voidable under either of the sections mentioned in Section 57-g, *its surrender cannot be required as a prerequisite to the proof of a claim.*" (Citing *Western Tie & Timber Co. v. Brown* (U. S. Sup.) (*supra*).

3 R. C. L. (Bankruptcy), p. 251, Sec. 80.

Upon careful examination, we have been unable to find any authority for placing a broader construction upon this provision of the act, Section 57-g, than stated in the authorities we have quoted, in the light of which there can be no doubt but that the rights of the trustee in this proceeding are confined to the provisions of Section 57-g and the Sections, 67-b and 67-e, therein mentioned.

This brings us directly to the consideration of appellant's second theory, that he is entitled to the surrender of the payments in question, in this proceeding, on the further ground that they constitute "state-law preferences."

(5) IS THE INSOLVENCY OF THE DEBTOR A NECESSARY ELEMENT OF PROOF, IN THIS PROCEEDING, IN ORDER TO REQUIRE THE SURRENDER OF A TRANSFER (i. e., PAYMENT) HELD NULL AND VOID AS AGAINST CREDITORS BY STATE LAW?

As we have shown—conclusively, we think—that a preference cannot be availed of by the trustee in this proceeding unless it is shown to be voidable under one or both of the sections, 60-b and 67-e, mentioned in Section 57-g; and as Section 67-e is the one relating specifically to "state-law preferences," it was necessary for the trustee, in order to prevail under his theory of a "state-law preference," to prove that the payments in question were made under such circumstances as to make them voidable preferences within the meaning of Section 67-e.

In order to do so, was it necessary for him to show that the debtor was "insolvent," in the bankruptcy sense, of an excess of liabilities over assets? In other words, is insolvency, in that sense, an essential element of the voidable preference as defined in Section 67-e?

The answer to this inquiry lies in the wording of Section 67-e, read in the light of Section 1 of the act (quoted *supra,* p. . .), providing that, "the words and phrases *in this act* shall, unless the same be inconsistent with the context, be construed as follows: (15) "A person shall be deemed 'insolvent' *within the provisions of this act* whenever the aggregate of his property," etc.

There being no inconsistency in the context of Section 67-e, with respect to the use therein of the word "insolvent" in that sense, it would seem to require no argument that insolvency in the bankruptcy sense is an essential element of a voidable preference as defined in Section 67-e.

The phrase, "and while insolvent," as used in Section 67-e, is in the nature of a condition or limitation, equally with its accompanying phrase "within four months prior to the filing of the petition." Both are obviously intended to place definite limits upon the voidability under the bankruptcy act of preferences prohibited by state laws. To give the word "insolvent" any other meaning in this connection than that prescribed in the act itself would not only violate the plain requirements of the act, but would make the limitation uncertain, and therefore valueless for the purpose intended by Congress, which obviously was to make it certain that no preference, whether a bankruptcy preference strictly speaking or a "state-law preference," need be sur-

rendered as a condition to the allowance of a claim which antedates the "four months' period" or is made while the debtor's assets exceed his liabilities.

Unless, then, the bankrupt is shown to have been insolvent in the bankruptcy sense at the dates of the several payments to Carson Pirie Scott & Company —and we think that, for the reasons we have pointed out in discussing the evidence in its bearing upon these payments treated as "bankruptcy preferences," that the evidence unquestionably establishes solvency in the bankruptcy sense—the trustee cannot prevail upon either of his theories in this proceeding, regardless of whether or not the payments constituted preferences as defined by state law.

While we feel convinced, therefore, that the court will find it unnecessary to go further in the consideration of the questions presented by this appeal, we will nevertheless discuss briefly the cases cited by the trustee in support of his contention that the payments in question were, in fact, preferences under the "Trust Fund Doctrine" of the Washington courts.

(6) WAS EACH OF THE PAYMENTS TO CARSON PIRIE SCOTT & COMPANY MADE UNDER SUCH CIRCUMSTANCES THAT IT PROPERLY COULD BE HELD NULL AND VOID AS AGAINST CREDITORS BY THE LAW OF THE STATE OF WASHINGTON, UNDER THE SO-CALLED "TRUST FUND" DOCTRINE OF THAT STATE?

While the Washington court in the decisions cited by appellant in support of an affirmative answer to this question (Appellant's Brief, pp. 56-67) has indulged in expressions to the effect that the test of the solvency of a corporation is "the ability to pay its debts in due course of business" and in some instances to the effect that a transfer which operates to prefer the creditor receiving it, is voidable, "no matter what the good faith of such creditor may be," it will be found upon an examination of them that in each instance the court has used those expressions in cases where the facts showed: with respect to insolvency, that the financial plight of the debtor corporation was much more serious and involved than mere inability to pay its debts as they matured; and, with respect to the creditor's knowledge of the debtor's financial condition, that almost invariably the creditor had actual or constructive knowledge of the fact of the debtor's insolvency, or of the fact that the transaction would work a preference.

So that, upon a careful examination of all the

cases cited by counsel in his brief, we think those expressions wherever they have been used by the state court, may fairly be regarded as *dicta,* rather than as definitely defined rules to be applied without qualification in all cases, regardless of the facts in the particular case.

In none of the cases cited, and in none of the Washington decisions applying the trust fund doctrine so far as we have been able to discover through careful search, has the court been called upon to apply that doctrine to a state of facts at all similar to the facts involved in the instant case.

In the case of *Thompson v. Huron Lumber Co.,* 4 Wash. 600, 30 Pac. 741, 31 Pac. 25, quoted at page 57 of appellant's brief, the debtor corporation gave a mortgage of all its property with the right in the mortgagor to continue in possession and operate the business. It was in this case that the Washington court first used the expression, "No matter what the good faith of its creditor is." But that expression was clearly *obiter,* since the court expressly found, in its opinion, that the creditor had knowledge both of insolvency and of the fact that the mortgage, from its very provisions, worked a preference. The question of the effect of lack of good faith was not involved in the decision.

Also in this case the court did not lay down the test of "inability to pay debts as they mature" as the

sole test of insolvency; but added other elements, including deficiency of assets to pay debts, saying:

> "When it (the debtor corporation) has reached a point *where its debts are equal to or greater than* its property, *and* it cannot pay in the ordinary course, *and* its business is no longer profitable, it ought to be wound up and its assets distributed."

It was in this case that the "trust fund doctrine" found its first expression in the Washington courts; and it appears from an examination of the decisions adopting and applying it, that the court in its subsequent decisions with practical uniformity quoted or referred to the expression, "no matter what the good faith of the creditor is," as a correct statement of the law in that regard, without any adequate consideration or explanation of its application, or attempt to define its meaning as used, and almost invariably under a state of facts where, as in this case, the question of the lack of good faith on the part of the creditor was not actually involved in the decision.

In the case of *Conover v. Hull,* 10 Wash. 673, 39 Pac. 166, quoted at pages 57-59 of appellant's brief, the decision was expressly based on facts showing collusion between the debtor corporation and the preferred creditor, in allowing the preferred creditors to obtain judgment ahead of other creditors, and also showing insolvency in the bankruptcy sense. In that case, as counsel for appellant concedes (Appellant's Brief, p. 59) Judge Dunbar held that the proof

must show (1) that the corporation was insolvent, and that (2) the preferred creditor had reasonable cause to believe that the debtor was insolvent.

In *In re Tacoma Ledger Co. v. Western Home Bldg. Assn.,* 37 Wash. 467, 79 Pac. 992, cited at pages 59-60 of appellant's brief and in which counsel argues that the Washington court reversed its previous ruling in the case of *Conover v. Hull, supra,* as to the necessity of "reasonable cause to believe," and returned to the original doctrine of *Thompson v. Huron Lumber Co.,* which counsel says has since been held by that court, namely, that "reasonable cause to believe need not be proved and that the good faith of a creditor is immaterial:"

The court stated (Opinion, p. 470) that "the single question" involved was "the right of one corporation to dispose of its capital stock and assets to another corporation, transferring its business to the purchasing corporation, itself ceasing to do business, neither corporation making provision for the payment of the debts of the selling corporation."

The purchasing corporation was not a creditor of the selling corporation, and therefore the case is clearly not in point.

And in the paragraph of the opinion quoted by appellant (p. 60) to the effect that the purchasing corporation's ignorance of the existence of indebtedness owing by the other would not avail it, for "with

or without that knowledge" the property is still a trust fund, etc., the court was applying that principle specifically, as shown by the sentence in the opinion immediately following, to "Attempts of this kind to avoid the payment of debts by consolidation." (Opinion, p. 473), and not otherwise.

The expression, "The good faith of the creditor is immaterial," does not appear in this opinion, obviously because the very nature of the transaction as it was described by the court implied lack of good faith.

In *Jones v. Hoquiam Lbr. & Shingle Co.*, 98 Wash. 172, 167 Pac. 117, quoted at pp. 60-61 of appellant's brief, the preference consisted, not of money paid in the usual course, but of real estate, and accounts receivable, so that there the creditor must have had cause to believe that the debtor was insolvent, since its action in making such an unusual payment was, of itself, sufficient to charge the creditor with "reasonable cause to believe." In this decision, after distinctly holding (Opinion, p. 175) that at the time of the transfer the liabilities exceeded the assets two to one, the court went back to the original announcement of the Trust Fund Doctrine in *Thompson v. Huron Lumber Co., supra,* quoting *verbatim* and with approval portions of the opinion in that case, including the expression, "no matter what the good faith of its creditor is," and also the test for the application of the Trust Fund Doctrine, as originally

announced in the Thompson case, embracing (as it did in that original case) not only the element of inability to pay in the ordinary course, but also the element of insolvency in the bankruptcy sense.

In *Benner v. Scandinavian-American Bank,* 73 Wash. 488, 131 Pac. 1149, quoted at page 62 of appellant's brief, the court will note from the portion of the opinion there quoted, that the debtor corporation was wholly insolvent in the bankruptcy sense, with liabilities five times the value of its assets, and that the preference was not a payment of money in full or on account, but was a transfer of property, a coasting vessel, to the value of about one-fourth of the total assets of the debtor corporation.

In *Williams v. Davidson,* 104 Wash. 315, 176 Pac. 334, quoted at page 63 of appellant's brief, while counsel's statement is true to the extent that the court held that there was no proof of "reasonable cause to believe," on the part of the creditor, that she was receiving a preference, on the other hand the court expressly found (Opinion, p. 321) that the preferred creditor "had ample notice of the insolvency of the corporation," for she had been given possession of its books and assets, showing insolvency in the bankruptcy sense, after she herself had threatened a receivership and had represented that the corporation was practically bankrupt. The creditor did not have reasonable cause to believe that she was being preferred in taking over the entire assets, be-

cause she required a certificate under the Bulk Sales Law of the state, which disclosed no outstanding creditors, but from which there had been omitted, by mistake, the names of certain creditors who afterward invoked the Trust Fund Doctrine. In this case the court again uses the expression, quoted from *Jones v. Hoquiam Lumber & S. Co.*, and in turn from *Thompson v. Huron Lumber Co., supra,* "No matter what the good faith of such creditor may be," but at the same time the opinion emphasized the fact that the creditor held to be preferred—and apparently very unjustly so, in view of the strong dissenting opinion by Judge Chadwick—did have knowledge of the debtor's insolvency. The majority opinion went upon the theory that where one of two innocent parties must suffer, the one least at fault must bear the burden.

In view of its application — or more accurately speaking, its entire lack of application, in most instances—to the facts in these cases, it seems impossible to determine, we think the court will conclude, just what the state court meant by the expression "No matter what the good faith of the creditor is."

It appears, however, that the Washington court has not applied the Trust Fund Doctrine as rigidly and unqualifiedly as the expressions used by the court in the cases cited by appellant, at first impression, would seem to imply; but that the court has expressly recognized an exception to the rule con-

tended for by appellant, within which exception we think the instant case clearly falls, namely, that where the debtor corporation, *though insolvent, is still a "going concern"* at the time of the preference, the creditor will be allowed to retain the same provided he received it in good faith.

This EXCEPTION to the general rule was announced in the case of *Brooks v. Skookum Mfg. Co.,* 9 Wash. 80, 37 Pac. 284, a case in which a chattel mortgage covering the debtor company's stock, fixtures and buildings was given to secure a past due indebtedness at a time when the debtor corporation had other past due indebtedness which it was unable to meet. The mortgage was accepted by the preferred creditor in good faith and on the understanding that the extension of indebtedness secured thereby would enable the debtor to obtain other extensions. Subsequently, the corporation ceased to do business because of the sudden departure of its president, Mr. Hall.

The court in its opinion, after stating that it was contended by the respondent that the action fell within the rule laid down in *Thompson v. Huron,* 4 Wash. 600, *supra,* said:

> "But it seems to us that a substantially different case is presented. . . . The corporation had conducted its business regularly and continuously up to the time Hall left. . . . The fact that it owed more than the value of its property, not including its good will, would not

necessarily prevent its continuing business. . . . The fact that the business had been a losing one, standing alone, clearly would not have been sufficient to avoid the mortgage. . . . We think the plaintiff was justified in assuming that it was able and intended to continue in business," and *held* that

"*What was said in that case* (*Thompson v. Huron,* 4 Wash. 600) *was confined to corporations having practically stopped business,* or reached a point where the corporate business could no longer have been successfully operated."

Brooks v. Skookum Mfg. Co., 9 Wash. 80, 37 Pac. 284.

This qualification by the Washington court of its Trust Fund Doctrine, confining the application of the same to corporations that have practically ceased to be "going concerns," following closely upon the original adoption of the Trust Fund Doctrine in the leading case of *Thompson v. Huron,* has not since been modified, or receded from, in any decision of the court so far as we have been able to discover.

Another case recognizing the "going concern" exception is *Strohl v. Seattle National Bank,* 25 Wash. 28, 64 Pac. 916, involving a chattel mortgage covering the bulk of the corporate assets given to secure an antecedent date at a time when the debtor corporation was clearly solvent in the bankruptcy sense, but was insolvent in the sense of inability to meet its debts as they matured. It, however, was a "going concern."

In its opinion, the court said:

> "The evidence in this case shows that when the mortgage was executed, the corporation was a 'going concern.' . . . Its business continued for months afterwards and other creditors continued to extend credit. . . . Appellant's counsel contends that this case falls within the same rule as the following cases: (*Thompson v. Huron* and others.) *We think not.* In the case of *Thompson v. Huron Lbr. Co., supra,* the court uses this language: 'When it has reached a point where its debts are equal to or greater than its property, and it cannot pay in the ordinary course, and its business is not longer profitable, it ought to be wound up and its assets distributed.' Such conditions are not shown to have existed in this case when the mortgage was given."

Held, not a recoverable preference.

Strohl v. Seattle Nat. Bank, 25 Wash. 28, 64 Pac. 916.

(See also *Hadley v. Bank of Ellensburg,* 67 Wash. 680, 123 Pac. 321.)

We find that Washington is included by the author of the article on corporations in Cyc. as among the states recognizing this exception to the Trust Fund Doctrine. The exception is there stated as follows:

> "Sec. 3076. *An exception to the rule* denying the right to prefer creditors is recognized in some jurisdictions in cases where the corporation, although insolvent, is a 'going concern,' at the time of the preference, doing business in the ordinary way; and under such circumstances, preferences to particular creditors are sustained if made in good faith. (Citing cases in footnote 72 from

various states, including Washington: *Brooks v. Skookum Mfg. Co.,* 9 Wash. 80, 37 Pac. 284); 14 Cyc. 999 (Corporations — Trust Fund Doctrine—Exception to Rule).

Counsel for appellant in his brief, in commenting upon the cases of *Jones v. Hoquiam Lbr. Co.,* 98 Wash. 172, 167 Pac. 117 (brief, p. 60) and *Benner v. Scandinavian-American Bank,* 73 Wash. 488, 131 Pac. 1149 (brief, p. 62), points out that in these two cases the debtor corporation continued to be a "going concern" after the giving of the preference; but it will be noted that in neither of these cases was the question of the applicability of the above exception presented, or considered by the court. They do not overrule *Brooks v. Skookum Mfg. Co., supra,* in this respect.

The case of *Vincent v. Snoqualmie Mill Co.,* 7 Wash. 566, 35 Pac. 396, is another case in which the Washington court declined to apply the Trust Fund Doctrine (distinguishing *Thompson v. Huron, supra*), although it found that the debtor corporation was in financial difficulty at the time of the preference and insolvent in the sense of being unable to pay its debts as they matured. In this case the debtor corporation gave a mortgage covering its entire property to secure certain past due indebtedness and certain advances made at the time, the purpose being to enable the debtor to continue its business. It was being pressed at the time and also it was doubtful whether

its assets equaled its liabilities. The court, in its opinion, said:

> "It is contended . . . that the case falls within the decision of this court in *Thompson v. Huron*, 4 Wash. 600, as appellant insists that the mill company was insolvent at the time this mortgage was executed.
>
> "It is not clearly apparent that the corporation was insolvent at said time. It had been operating its mill up to a few days before the execution of the mortgage. It was then being pressed by its creditors and was unable to pay them at that time and it is doubtful whether the general market value of its property equaled the amount of its indebtedness; but its evident desire was to continue its business and to get the matters of its corporation in better shape. . . . And it fairly appears from the record that the mortgage was executed in good faith for that purpose. . . . We are of the opinion that this case does not fall within the rule laid down in *Thompson v. Huron Lbr. Co.*, under the facts above stated."
>
> *Vincent v. Snoqualmie Mill Co.*, 7 Wash. 566, 35 Pac. 396.

In most of the cases in which preferences have been declared recoverable under the Trust Fund Doctrine, it appeared that the debtor corporation had ceased to be a "going concern" at the time of the preference, and that fact was emphasized in the decision. See:

Leslie v. Wilshire, 6 Wash. 282, 33 Pac. 505.
Smith v. Hopkins, 10 Wash. 77, 38 Pac. 854.
Biddle Pur. Co. v. Port Townsend Steel Co., 16 Wash. 681, 48 Pac. 407.
Cook v. Moody, 18 Wash. 114, 50 Pac. 1020.

It will be recollected in this connection that, as testified by Mr. LeSourd, "this business was a going business up until it was turned over to the state court receivers" (R. 44), about two weeks after the last payment to Carson Pirie Scott & Company. The same witness testified: "So far as the Elliott and O'Brien interests are concerned, it was the expectation up to say the 2nd of May, 1921, when Hart came from Seattle and interviewed me, that the business would be continued." (R. 44.)

Reduced to its simplest terms, appellant's contention that the payments in question to Carson Pirie Scott & Company were recoverable preferences, is based upon the theory that mere proof that the indebtedness upon which the said payments were made was past due and that the creditor to whom the indebtedness was owing knew that it was past due, is sufficient to constitute a voidable preference under the Trust Fund Doctrine of the state, assuming that the payments resulted in a preference. (Appellant's Brif, p. 67.)

The Washington decisions cited by appellant clearly do not support this contention; and, in the light of the decisions to which we have directed the court's attention as well as those cited by appellant, the trustee has failed—unquestionably, we think—to establish that the payments to Carson Pirie Scott & Company were made under circumstances such that the Washington court would hold them null and

void as against creditors under the State Trust Fund Doctrine.

This appellee, Carson Pirie Scott & Company, therefore respectfully submits that the decree appealed from in this matter should be affirmed as to it.

Respectfully submitted,

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